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arts LAW MEMO

Maintaining Trust and Accountability

What can nonprofit arts organizations learn from the recent corporate failures and scandals?

Certainly, none of us is establishing an offshore office to avoid taxes, issuing stock options, or giving "imperial" CEOs lavish retirement perks. Nor are we shredding documents or using overly aggressive accounting practices.

The business scandals may appear to be about a few greedy executives who made their companies' performances appear better than they actually were. But fundamentally, the corporate credibility crisis is about broken trust and like publicly held corporations, nonprofit organizations depend directly on sustaining public confidence.

How many times have you been counseled to run your nonprofit arts organization more like a business?

This issue of *Arts Law Memo* summarizes some of the *Principles of Corporate Governance*, which were issued by The Business Roundtable this past May. It also outlines the most essential accountability standards and reports on the new local charity reporting service that was recently intiated by the St. Louis-area Better Business Bureau.

CORPORATE BEST PRACTICES

In the wake of the Enron bankruptcy, The Business Roundtable, an association of the chief executive officers of leading corporations with a combined workforce of more than ten million employees, called on companies to adopt a number of "best practices" in corporate governance, "which would help restore trust in American business."

The guidelines were published in a 28-page white paper entitled "Principles of Governance." While the document contains many references to stockholders, its standards of conduct apply, with some poetic license, to nonprofits.

GUIDING PRINCIPLES

The Business Roundtable supports six guiding principles:

- The paramount duty of the board of directors is to select a chief executive officer and to oversee that person and other senior management in the competent and ethical operation of the corporation on a day-to-day-basis.
- It is the responsibility of management to operate the corporation in an effective and ethical manner. Management should never put personal interests ahead of or in conflict with the interests of the corporation.
- It is the responsibility of management, under the oversight of the board, to produce financial statements that fairly present the financial conditions of the corporation.
- It is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles (GAAP).

(Generally, nonprofit arts organizations with annual revenue of less than $150,000 do not engage external auditors.)

- It is the responsibility of the audit committee to inform the board, in a forthright and timely manner, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation's financial condition, or weaknesses in internal control systems.
- The corporation has a responsibility to deal with its employees in a fair and equitable manner.

KEY CORPORATE ACTORS

According to the white paper,

Published by the St. Louis Volunteer Lawyers and Accountants for the Arts (VLAA), *Arts Law Memo* is mailed, free of charge, to more than 850 Missouri and Southwestern Illinois arts organizations, VLAA volunteers and corporate sponsors.

VLAA helps artists and arts organizations solve and avoid legal and accounting problems by:

- Making referrals to lawyers and accountants;
- Mediating arts-related disputes;
- Publishing *Arts Law Memo* and concise how-to guides;
- Sponsoring seminars and public forums;
- Arranging for guest speakers;
- Maintaining a reference library;
- Operating an arts space clearinghouse;
- Supplying model contracts and other arts law and business materials;
- Facilitating meetings;
- Conducting and disseminating research on issues affecting the arts;
- Contributing articles to publications;
- Collaborating on arts advocacy initiatives;
- Matching volunteers with arts organizations seeking board members; and
- Providing access to the national VLA network.

ST. LOUIS VOLUNTEER LAWYERS AND ACCOUNTANTS FOR THE arts

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"Effective corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with others in the corporate structure."

The Business Roundtable says relationships should be characterized by candor, fairness and a commitment to compliance with applicable laws.

While the board is responsible for hiring the chief executive and overseeing his or her performance, "effective corporate directors are diligent monitors, but not managers, of business operations.

"...Good corporate governance is far more than a "check-the-box" list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice."

BOARD ROLES

The white paper outlines numerous board responsibilities. Most notably, perhaps, it calls on board members to maintain an attitude of "constructive skepticism" by asking incisive and probing questions.

Specific oversight functions include:

• Planning for management succession;

• Understanding, reviewing and monitoring implementation for the corporation's strategic plans;

• Understanding and reviewing annual plans and budgets;

• Focusing on the integrity and clarity of the corporation's financial statements and financial reporting;

• Engaging outside auditors;

• Advising management on significant issues facing the corporation;

• Reviewing and approving significant corporate actions;

• Nominating new directors; and

• Reviewing the CEO's performance.

STAFF RESPONSIBILITIES

The Business Roundtable notes that U.S. corporations have traditionally vested responsibility in the CEO rather than diffusing high-level responsibility among several individuals. The organization believes this model has generally served corporations well.

(Many arts organizations, particularly nonprofit theatres, have adopted a dual leadership model in which the artistic director and managing director share leadership).

According to the white paper, senior management is charged with:

• Operating the corporation;

• Taking the lead in strategic planning;

• Developing annual operating budgets and plans;

• Selecting qualified employees;

• Identifying and managing risks; and

• Producing financial statements that fairly represent the corporation's financial conditions.

The Roundtable believes that senior management, and particularly the CEO, should set a tone that establishes "a culture of integrity and legal compliance communicated to personnel at all levels of the corporation."

Finally, corporations should establish procedures that allow employees to alert management and the board to potential misconduct without fear of retribution.

OVERSIGHT FUNCTION

Noting that no one board structure or approach to operations is right for every corporation, the white paper does not recommend a specific board size. However, it does recommend "monitoring the mix of skills and experience of directors in order to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function properly."

The white paper also says board members "should have a substantial degree of independence from management."

It recommends a committee structure "to address key areas in more depth than may be possible in a full board meeting." Committee responsibilities should be clearly defined and understood.

Key committees include audit, nominating and compensation. The latter has responsibility for overseeing the corporation's overall compensation programs and setting the CEO's compensation.

BOARD OPERATIONS

The white paper reminds board members that serving on a board requires significant time and attention. It encourages directors to participate in board meetings, review relevant materials, serve on committees and prepare for meetings.

The Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold. However, the organization notes that "service on too many boards can interfere with an individual's ability to perform his or her responsibilities."

Other recommendations include:

• **Board Meetings.** Careful planning of the board's agenda, including adequate time for discussion and a healthy give-and-take between board members and management.

• **Information.** In order to perform effectively, the board should have accurate and complete information — ideally from a variety of sources. Materials should be provided before meetings to allow time to reflect on key issues and to request supplementary information, if necessary.

• **Education.** New board members should be provided with orientation materials and receive briefings on organizational operations. The Business Roundtable also encourages corporations to provide educational opportunities for the entire board on an ongoing basis.

• **Outside Advisors.** When appropriate, boards should seek counsel from outside advisors.

• **Evaluation.** The board should conduct periodic self-evaluations to determine whether the board and its committees are functioning effectively.

FOR MORE INFORMATION

A copy of the Business Rountable's "Principles of Corporate Governance" can be obtained by visiting the organization's web site (www.brt.org).

Selected Nonprofit Accountability Standards

Nonprofits should operate in accordance with an annual budget, which has been approved by the board of directors.

Nonprofits should create and maintain financial reports on a timely basis that accurately reflect the financial activity of the organization. The reports should include two items: a statement of financial position (a balance sheet) that shows assets and liabilities and a statement of activity (income and expenses) that compare the activity to date with the budget.

Internal financial statements should be prepared no less frequently than quarterly, should be provided to the board of directors, and should identify and explain any material variation between actual and budgeted revenues and expenses. Reports should contain only essential information that is presented clearly and concisely.

For nonprofits with substantial annual revenue, the accuracy of year-end financial reports should be audited by a Certified Public Accountant. The Illinois Arts Council requires applicants with total revenue in excess or $150,000 to supply an audit; the Missouri Arts Council's threshold is $500,000.

Nonprofits should provide employees with a confidential means to report suspected financial impropriety or misuse of organization resources.

Nonprofits should have written financial policies governing the following matters, where appropriate: (a) investment of the assets of the organization; (b) internal control procedures; (c) purchasing practices; and (c) compensation, including salary and benefits.

Nonprofits should have a conflict of interest policy for both the staff and the governing body. Policies should address all instances where an organization's business or policy decisions can result in direct or indirect financial benefit to a member of the board or staff by setting out specific procedures to address actual, potential or perceived conflicts.

Nonprofits should have a policy promoting pluralism and diversity within the organization's board, staff and constituencies. While organizations vary widely, every organization should establish a policy consistent with its mission statement that fosters inclusiveness.

Nonprofits must be aware of and comply with all applicable federal, state and local laws. This may include, but is not limited to, the following activities: complying with laws and regulations related to fund raising, financial accountability, human resources, lobbying and political advocacy and taxation.

Nonprofits should spend funds in accordance with donor intentions.

Nonprofits should respect the privacy of donors and safeguard the confidentiality of information which the donor reasonably would expect to be private. They should honor requests to remain anonymous.

Nonprofits should be accessible and responsive to members of the public and the media who express interest in the affairs of the organization.

Sources: BBB Wise Giving Alliance Standards for Charitable Accountability, Minnesota Council of Nonprofits “Principles & Practices for Nonprofit Excellence,” Maryland Association of Nonprofit Organizations “Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector”

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BBB INTRODUCES LOCAL CHARITY REPORTING SERVICE

In response to the growing demand for objective information on charities, the Better Business Bureau of Eastern Missouri and Southern Illinois recently introduced a local charity review program. The program will offer reports on local charities, including whether an organization meets the voluntary BBB Wise Giving Alliance Standards for Charitable Accountability.

The goals of the local BBB program are to provide a way for St. Louis area donors to make wise giving decisions and to provides organizations with a means of establishing their accountability to the public.

The 23 standards address governance, finance and willingness to disclose information to the public. The standards go beyond the requirements of local, state and federal laws and regulations. For example, Standard #15 requires nonprofits to “provide, on request to all, a board approved annual budget for its current fiscal year, outlining projected expenses for major program activities, fund raising and administration.”

The standards also call for nonprofits to have an annual report available on request. This standard could be problematic for arts organizations, since, unlike social services agencies, arts organizations rarely publish annual reports.

The BBB will collect information on local charities in response to inquiries from the public. Organizations may also elect to complete the BBB’s 4-page questionnaire, which can be obtained by calling James Judge, director of charity review, 314/645-0606.

The completed questionnaires and attachments will be evaluated by BBB staff and summarized in a report that will be available free of charge by mail by calling the Bureau at 314/645-3300, or by visiting the BBB's web site, www.stlouis.bbb.org.

The local charity review program supplements the reports on nationally soliciting charitable organizations that are published by the Council of Better Business Bureau's Wise Giving Alliance.

At this time, the BBB in Kansas City has no plans to institute a local review program.